

BASIC LEGAL CONSIDERATIONS WHEN STARTING YOUR OWN BUSINESS

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Starting your own business can be very exciting, for it allows you the opportunity to shape a creative idea into a business reality. However, making the transition from idea to reality requires serious consideration of the different types of business entities available so that you are sure to select the form of entity which best suits the needs of your business.

A. TYPES OF ENTITIES

1. Corporation, either “C” corp., or “S” corp.
2. Partnership, either General Partnership or Limited Partnership
3. Limited Liability Company or Limited Liability Partnership
4. Sole Proprietorship

B. GENERAL CONSIDERATIONS WHEN CHOOSING AN ENTITY

1. Tax Issues
2. Liability Issues
3. Management Structure
4. Ability to transfer interests in your business
5. Need to observe statutory formalities upon formation

■ “C” CORPORATION

A “C” corp. is what one typically envisions upon hearing the word “corporation.” A “C” corp. has shareholders, as well as a board of directors and officers. The shareholders are the owners of the corporation; they receive shares of stock in exchange for their capital contributions made to the corporation. Capital contributions can be made in different forms, whether it be cash, property or services to the corporation. The Board typically acts as strategic planners for the corp., setting the policies, procedures and long term objectives of the corporation. Some of their actions and decisions are subject to the approval of the shareholders. Similarly, corporate officers manage the daily operations of the corporation subject to the supervision of the Board. This type of *centralized management* is considered one of the advantages of the corporate entity. Other advantages include *limited liability* of the owners and *free transferability of interests*. First, owners of a corporation enjoy limited liability (that is, they are liable for the obligations of the corp. only to the extent of their investment in the corp. Second, an owner’s interest in a corporation may be transferred easily to a third party or back to the corporation without disrupting the corporation’s existence. A disadvantage of the “C” corp. is the concept of “*double taxation*”. The profits and losses of a corporation will first be taxed at the entity level, and then at the shareholder level when dividends are paid by the corporation. Likewise, the need to *strictly observe statutory formalities* in order to

become legally recognized is often viewed as a disadvantage in terms of time and expense.

- **“S” CORPORATION**

The structure of an “S” corp. is exactly the same as that of a “C” corp., differing only in its federal and state income tax treatment. With the “S” corp. structure, the corporation is not considered a separately taxable entity. The corporation itself does not pay taxes. Instead, taxes “*flow through*” to the shareholders, just as partners are taxed in a partnership. Thus, taxes are paid only once. To qualify for taxation under Subchapter “S” of the Internal Revenue Code, the corporation must comply with certain guidelines set forth by the IRS. For example, there must be 75 or fewer shareholders, the shareholders must be individuals (with some discrete exceptions), the corporation may only issue one class of stock, and the corporation cannot own more than 80% of the stock of another corporation unless it owns 100% of that corporation and elects to treat it as a qualified “S” subsidiary. In practice, the “S” corp. tends to be a smaller operation than the “C” corp.

- **GENERAL PARTNERSHIP**

By definition, a partnership is “an association of two or more persons who carry on as co-owners of a business for profit”. What this means is a general partnership is formed as soon as at least two persons voluntarily associate together for the purpose of carrying on a business for profit. There are *no required statutory formalities* which must be observed in order to create its legal existence. A partnership may be formed orally or even implied by the conduct of the parties. Of course, it is better practice to have a written agreement so that all the parties are in agreement as to their rights and obligations. (Nonetheless, Rhode Island statutory law prescribes certain rights and duties which will govern in the event there is no written agreement.) Another advantage to the general partnership structure is “*flow through*” taxation at both the federal and state level. The partnership is not a separately taxable entity. Thus, income and losses are passed to the partners who are taxed in their individual capacities. Appointment of a managing general partner can achieve *centralized management* of the partnership structure, yet another advantage. A major disadvantage for the general partnership is lack of limited liability. Partners are *liable to the full extent* of their personal assets, as well as partnership assets, for debts or obligations of the general partnership. Another drawback is *the limited ability of a partner to transfer his/her partnership interests* without the consent of his/her partners. Likewise, the transfer of one’s interest may affect the continued existence of a general partnership. Technically, a partnership dissolves whenever a partner ceases to be associated with the partnership (although continued existence can be preserved if provided for in the partnership agreement).

- **LIMITED PARTNERSHIP**

The limited partnership structure is generally the same as that of the general partnership but with several basic differences. First, there are *two basic classes of partners*, general

partners and limited partners. The general partners retain the same liabilities as a partner in a general partnership; while the limited partners are liable for the obligations of the limited partnership only to the extent of their capital contributions, plus any distributions made by the partnership to the limited partners. Hence, the liability of limited partners is much like that of shareholders of a corporation. Another advantage is the *ease of transferability* of the limited partner interest. Unlike the transfer of a general partner interest which requires consent, the transfer of a limited partner interest is subject only to limitations contained within the limited partnership agreement, as well as by applicable securities laws. Yet, limited liability does not come without costs. In order to preserve their limited liability, limited partners *may not participate in the control* and management of the business. Another disadvantage is the *need to comply with certain statutory requirements* in order to establish its legal existence.

▪ **LIMITED LIABILITY COMPANY**

The limited liability company is a relatively new form of business entity. Statutorily-based, it represents a hybrid of both the corporate and partnership entity. When properly structured*, an LLC can achieve *flow-through taxation*. The LLC also requires only one member. Similar to a corporation, members of an LLC may actively participate in the control of the LLC without losing their *limited liability*. The combination of these features make the LLC an ideal business form. Drawbacks include the need to observe statutory formalities and the need to obtain member *consent in order to assign* your membership interest in the LLC to a third party. Unique to the LLC is certain defining terminology; specifically, its owners are referred to as “members” and control lies in the hands of “managers” which are like directors of a corporation.

*To achieve partnership tax status, the LLC must have two or fewer of the following four features: (1) Limited liability, (2) Centralized management, (3) Free transferability of interest and (4) Continuity of existence. By limiting the ability to transfer membership interests in the operating agreement and specifying a limited duration for the life of the LLC, partnership taxation is easily achieved.

▪ **LIMITED LIABILITY PARTNERSHIP**

A limited liability partnership is essentially a general partnership with *limited liability* for all members. Unlike the general partnership, however, the LLP is created by following statutory requirements. Similar to a general partnership, the LLP is not taxed as a separate entity and, therefore, all members are subject to *flow-through taxation* at the state and federal level. The LLP was formed to protect innocent partners from liability due to misconduct of other partners. This limited liability of all members is one important way in which the LLP differs from the general partnership. It is also a significant advantage in choosing this type of entity. The LLP offers another advantage over the limited partnership, the LLC, and the corporation because LLP members can directly *participate in management and control* of the entity without the threat of vicarious liability. Unlike limited partners, LLP nonmanaging partners are liable only for participating in or supervising particular conduct or partners. In addition to misconduct,

LLP members are not individually liable for all of the debts of the business. Another advantage to the LLP form is that changes in the partnership after registration, such as transfer of one partner's interest, *does not dissolve* the partnership. Drawbacks to the LLP form include the lack of informality that characterizes general and limited partnerships. The LLP statute sets forth strict registration requirements, restricts the name choice for the LLP, and requires the LLP to carry specific amounts of insurance. Registration and renewal, although capped at a certain amount, can be very costly because it includes a fee for each partner. Failure to comply with the statutory requisites most often causes the entity to be *deemed a general partnership*, while a limited partnership that fails to comply with the statute will generally retain limited partnership status. Finally, it is worth noting that although members have limited liability, shareholders of a corporation have no liability at all based on their status.

Usually an LLP is formed by a partnership that wished to register as an LLP. Registering as an LLP does not involve the creation of a new business or legal entity, so it is relatively free from the consequences that characterize the change from one corporate form to another.

▪ **SOLE PROPRIETORSHIP**

The sole proprietorship is the least complicated type of business entity. Here, a person is engaged in business for him or herself. This is usually the entity of choice for anyone interested in starting a small-scaled business. An obvious advantage is *the absence of any statutory formalities* with which you must comply upon forming your business. Another advantage is *easy transfer of business interest*. A sole proprietor who no longer wishes to own her business may sell both the assets and liabilities of the business to an interested buyer. An exception to this is when a sole proprietor dies. In that case, proper estate planning is the only way to ensure the continued existence of the business. Finally, the sole proprietorship *avoids the double taxation* of a "C" corp. and personally retains all of the profits of the business. The flipside to taxation at the individual level is that the sole proprietor *must assume all losses*; there are no partners with whom to share the losses. This can work as a disadvantage, especially during the formative years of your business, when losses tend to be greatest. Perhaps the greatest disadvantage, however, is the fact that the owner of a sole proprietor is *fully liable for all obligations* of the business to the extent of both her personal and business assets. The sole proprietor has no one with whom to share any of the liability. If a sole proprietor should ever decide to share the responsibilities of her business with another individual (e.g., sharing of profits/losses, sharing the management function), the sole proprietorship will immediately become a partnership, regardless of the intent of the parties.

Choice of Entity - Advantages and Disadvantages

"C" Corporation

Advantages

- Shareholder Limited Liability
- Transferability of Interests
- Centralized Management

Disadvantages

- Double-taxation
- Annual Corporate Maintenance
- Inflexibility in Structuring Investment Opportunities

"S" Corporation

Advantages

- Shareholder Limited Liability
- Transferability of Interests
- Flow-Through Taxation
- Centralized Management

Disadvantages

- Annual Corporate Maintenance
- Inflexibility in Structuring Investment Opportunities

General Partnership

Advantages

- Flow-Through Taxation
- Centralized Management
- Flexibility in Structuring Investment Opportunities

Disadvantages

- Consent Prior to Transfer of Partnership Interest

Limited Partnership

Advantages

- Limited Liability for Limited Partners
- Flow-Through Taxation
- Centralized Management
- Flexibility in Structuring Investment Opportunities

Disadvantages

- Unlimited Liability for General Partners
- Limited Partners Not Able to Participate in Control of Business
- Required Statutory Formalities
- Consent Prior to Transfer of Partnership Interest

Limited Liability Partnership

Advantages

- Member Limited Liability
- Ability to Participate in Management and Control of Business
- Flow-Through Taxation
- Does not Dissolve when Partners Change

Disadvantages

- Required Statutory Formalities
- Cost of Registering and Renewal

Limited Liability Company

Advantages

- Member Limited Liability
- Ability to Participate in Control of Business
- Flow-Through Taxation
- Centralized Management

Disadvantages

- Required Statutory Formalities
- Consent Prior to Transfer of Membership Interest

Sole Proprietorship

Advantages

- No Statutory Organizational Formalities
- Transferability of Interests in Most Cases
- Taxed as an Individual

Disadvantages

- Unlimited Liability
- Difficult to Transfer Interest Upon Death